United States Court of Appeals

for the Second Circuit

APPELLANT'S REPLY BRIEF

ORIGINAL

75-4193

To be argued by
ALFRED D. YOUNGWOOD

United States Court of Appeals

For the Second Circuit

AHMET ERTEGUN AND IOANA ERTEGUN,
Petitioner-Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee,

GERALD WEXLER AND SHIRLEY WEXLER,
Petitioner-Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee,

NESUHI ERTEGUN AND BELKIS ERTEGUN,
Petitioner-Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

On Appeal from the United States Tax Court

REPLY BRIEF FOR PETITIONERS-APPELLANTS AHMET ERTEGUN AND IOANA ERTEGUN, GERALD WEXLER AND SHIRLEY WEXLER, AND NESUHI ERTEGUN AND BELKIS ERTEGUN

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1. The Commissioner's argument that the stated invoice price and the timing of book entries control the determination of gross income is contrary to law.

The Commissioner asserts that Atlantic's sales income must include the entire invoice price merely because the literal invoice terms provided for payment before the 10 percent reduction in price was effectuated by the return privilege. But application of this standard would result in Atlantic being taxed on income it never had a right to receive and never did receive. Such a result defies common sense and is inconsistent with the decisions which hold that rebates or credits given after billing or after payment may properly reduce gross income to reflect the net sales price. *Atzingen-Whitehouse Dairy, Inc.*, 36 T.C. 173 (1961), *Acq.* 1961-2 Cum. Bull. 3; *Pittsburgh Milk Co.*, 26 T.C. 707 (1956), *Acq.* 1962-2 Cum. Bull. 5.

The Commissioner attempts to distinguish *Atzingen-Whitehouse Dairy, Inc., supra,* and *Pittsburgh Milk Co., supra,* by arguing that "[i]n these cases there was a definite purpose to circumvent a regulated price, and the parties established that the actual agreement was for the reduced amount." (Comm. Br. 16). The Commissioner asserts that in the instant case the taxpayers have not established that the invoice price did not constitute the actual selling price.

The Commissioner is wrong. The record is clear and unequivocal that the invoice price did not control and that all Atlantic was ever entitled to receive, and ever did receive, was 90 percent of the invoice price plus some worthless records (43a-52a, 90a-92a). Although this long stand-

ing arrangement was not memorialized in writing,* it was always understood and agreed by Atlantic and the distributors that the distributors were required to pay only 90 percent of the invoice price. Indeed, that the distributors always availed themselves of the full return privilege, a fact which the Commissioner continues to concede (Comm. Br. 6, 21), is itself sufficient to demonstrate that at the time of sale, Atlantic was only entitled to 90 percent of the invoice price.

2. The Commissioner has mischaracterized the substance and effect of the 10 percent return privilege.

The Commissioner argues that Atlantic's 10 percent return privilege operated not as a 10 percent price discount, but as a sale or return mechanism under which Atlantic ultimately sold to the distributor only 90 percent of the records initially sold. That is a serious mischaracterization of the 10 percent return privilege which finds no support in the record.

Atlantic sold to the distributor all the records invoiced. Thereafter, whether the distributor had sold 80 percent, 90 percent or 100 percent of such records, Atlantic received only 90 percent of the invoice price plus a number of worthless records equal to 10 percent of the original number of records sold. The impact of this policy on each distributor varied, of course, depending upon whether he sold more than 90 percent of the records purchased. If the distributor sold more than 90 percent of the records he purchased from Atlantic, the 10 percent return privilege

* There were no written contracts between Atlantic and its distributors. The distribution agreements were oral and were in accordance with industry norms and practices. (60a)

clearly operated as a price discount to him; if he sold less than 90 percent, he might have considered the 10 percent return privilege either as a price discount or as a mechanism for returning some unsold records.

However, for the purposes of this case, the number of records sold or not sold by the distributor is wholly irrelevant. Atlantic's agreement with the distributor required him to pay only 90 percent of the invoice price no matter how many Atlantic records the distributor did or did not sell.

3. The Commissioner's assertion that Atlantic's 10 percent return privilege and its policy of negotiating returns over and above that limit were part of the same sale-or-return arrangement is incorrect.

The Commissioner incorrectly asserts that the 10 percent return privilege and the negotiated returns were "part of the same sale-or-return arrangement." The Commissioner further states that the Tax Court so found (Comm. Br. 20).

The Tax Court held as a matter of law that the 10 percent return privilege was a sale or return contract subject to a 10 percent limitation, a holding which we have argued in our main brief is incorrect (Taxpayers' Br. 12-14). At no time, however, did the Tax Court find or even suggest that the 10 percent return privilege and the negotiated returns were part of the same arrangement because, of course, they were not.

The number of records returned by a distributor under the 10 percent return privilege was entirely unrelated to the

distributor's success in selling records acquired from Atlantic; it merely implemented the understanding of the parties that only 90 percent of the invoice price need be paid since the last 10 percent of such price could be satisfied by the return of worthless Atlantic records whether or not purchased by the distributor from Atlantic. Under the negotiated return policy, however, Atlantic negotiated an ad hoc arrangement each time a request was made by a distributor. These ad hoc arrangements varied widely, and depended on the value of the distributor to Atlantic, his promotional efforts on Atlantic's behalf and the number of unsold records purchased from Atlantic which he wished to return (49a, 79a). The two practices were thus separate and distinct, were accounted for in different ways and were considered separate and distinct practices in the trade (49a-51a, 79a).

It is important for this Court to understand, as apparently the Commissioner and the Tax Court have not, that the practices in the record industry are substantially different than the practices in the publishing industry described in *J. J. Little & Ives Co.* v. *Commissioner,* 25 CCH Tax Ct. Memo. 372 (1966) and *Scott Krauss News Agency, Inc.* v. *Commissioner,* 23 CCH Tax Ct. Memo. 1007 (1964). *See,* Taxpayers' Br. 12-14.

4. The requirement of the return of worthless records was not sufficient to defeat an accrual.

In response to taxpayers' alternative argument that Atlantic's obligation under the 10 percent return privilege was an appropriate accrual at the time of the sale of the singles to which it related, the Commissioner asserts that although "the contingencies relating to the close of the

calendar quarter and the issuance of a return authorization may be viewed as technicalities," the requirement that the distributors return the single records prevents accrual of Atlantic's obligation* (Comm. Br. 27).

Atlantic's obligation under the 10 percent return privilege was fixed and definite at the time of sale. The return of the records was merely a ministerial act required for the distributor to receive the credit. Even if a distributor sold every record that he had purchased from Atlantic, he always obtained and returned sufficient records to receive the full credit. As this Court held in *Central Cuba Sugar Co.* v. *Commissioner*, 198 F.2d 214 (2d Cir. 1952), *cert. denied*, 344 U.S. 874 (1952), an insubstantial contingency which might relieve a taxpayer from an obligation should not defer accrual.

The Commissioner purports to distinguish *Central Cuba Sugar Co., supra,* by asserting that in that case only "conditions subsequent" and insubstantial contingencies remained, while in this case the contingency is substantial. This distinction is without substance. In *Central Cuba Sugar Co., supra,* the taxpayer had an "established liability" to pay brokerage commissions. This Court noted, however, "that if the contract were not carried out the broker forfeited his Commission." 198 F.2d at 217. In

* The Commissioner also asserts in a footnote to this argument (Comm. Br. 27) that Atlantic made no effort to estimate with reasonable accuracy the aggregate credits it anticipated from the 10 percent return privilege and the negotiated return policy. This argument is premised on the same incorrect assumption discussed above that the 10 percent return privilege and the negotiated returns were a single arrangement. As set forth above, these matters were separate and distinct obligations, one fixed and determinable and the other contingent. Atlantic clearly determined with accuracy its liability under the fixed and determinable item—the 10 percent return privilege.

characterizing the contingency that the contracts might not be performed as a "condition subsequent", this Court relied upon the same principle taxpayers urge here; *i.e.*, not every conceivable contingency that will defeat a liability serves to defer accrual. The contingency that the distributors might not return the worthless records is as much a "condition subsequent" as the possibility the contracts might not be performed in *Central Cuba Sugar Co.* In both cases, there was an insubstantial contingency, subsequent to sale, that raised the possibility that the obligation which attached at the time of sale, might subsequently be defeated.

5. *Central Cuba Sugar Co.* is the law of this Circuit.

The Commissioner incorrectly asserts that *Central Cuba Sugar Co., supra,* is of limited continuing precedential value because the Supreme Court in *American Automobile Association* v. *United States,* 367 U.S. 687 (1961) held in effect that the repeal by Congress of section 462 of the Code was a "prohibition on the use of 'reserves' and the deduction of estimated future expenses" (Comm. Br. 33).

The Court in *American Automobile Association* focused upon and dealt with the special circumstances of the enactment and repeal of section 452 relating to prepaid income and the subsequent legislative activity relating to that subject matter. The Court did not directly or indirectly deal with the repeal of section 462 which related to deductions for reserves for estimated future expenses. Moreover, *Central Cuba Sugar Co., supra,* did not involve reserves for estimated future expenses. Rather, as this case, it involved

the appropriate year in which to deduct established liabilities.*

Neither the repeal of section 462 nor the *American Automobile Association, supra,* case is of relevance to either *Central Cuba Sugar Co., supra,* or to this case and the Commissioner's references thereto are misleading and inappropriate.

Dated: New York, New York
January 9, 1976

Respectfully submitted,

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* This Court clearly indicated that *Central Cuba Sugar Co.* was the law of this Circuit in *C.I.R.* v. *Fifth Avenue Coach Lines, Inc.,* 281 F.2d 556, 562, 563 (2d Cir. 1960), *cert. denied,* 366 U.S. 964 (1961), which was decided several years after the repeal of section 462. *See also, W. S. Badcock Corp.* v. *Commissioner,* 491 F.2d 1226, 1228, note 4 (5th Cir. 1974).

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Affidavit of Service by Mail

In re:

Ahmet Ertegun v Commissioner of Internal Revenue

State of New York
County of New York, ss.:

Harry Minott,

being duly sworn, deposes and says, that he is over 18 years of age. That on JAN 9 - 1976, 197..., he served 3 copies of the within Brief in the above named matter on the following counsel by enclosing said three copies in a securely sealed postpaid wrapper addressed as follows:

Scott T. Crampton, Esq.
Assistant Attorney General
Tax Division
Department of Justice
Washington, D.C. 20530

Att: Arthur Bailey, Esq.

(Attorney for Respondent-Appellee)

and depositing same in the official depository under the exclusive care and custody of the United States Post Office Department within the City of New York.

and depositing same at the Post Office located at Howard and Lafayette Streets, New York, N. Y. 10013.

Harry Minott

Sworn to before me this 9th day of Jan. 1976

Jack A. Messina

JACK A. MESSINA
Notary Public, State of New York
No. 30-2673500
Qualified in Nassau County
Cert. Filed in New York County
Commission Expires March 30, 1977